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**FISCAL IMPACT STATEMENT**

**LS 7062**

**BILL NUMBER:** SB 441

**NOTE PREPARED:** Feb 4, 2015

**BILL AMENDED:**

**SUBJECT:** Eliminates Certain Tax Deductions and Credits.

**FIRST AUTHOR:** Sen. Hershman

**BILL STATUS:** As Introduced

**FIRST SPONSOR:**

**FUNDS AFFECTED:** X GENERAL  
X DEDICATED  
FEDERAL

**IMPACT:** State & Local

**Summary of Legislation:** The bill contains the following provisions:

*Property Tax - WWI Veteran Deduction:* It eliminates the World War I veteran property tax deduction for property taxes imposed for an assessment date after 2015.

*Property Tax - Enterprise Zone Investment Deduction:* It eliminates the enterprise zone investment deduction for qualified investments made after May 1, 2016.

*Sales Tax - Double Direct Test:* It eliminates the double direct test for the gross retail tax exemption for various transactions involving various types of tangible personal property. It specifies that the exemption applies if the tangible personal property is acquired for direct use or consumption in the production of tangible personal property when the person acquiring the property is occupationally engaged in the business of producing tangible personal property.

*Income Tax - Adjustments, Deductions, and Credits:* It eliminates various adjustments for purposes of determining Indiana adjusted gross income (AGI). It also eliminates various income tax deductions, exemptions and credits.

*Business Income Definition:* It provides that business income is all income apportionable to the state under the Constitution of the United States.

*Interest Expense Adjustment:* It broadens the add back to Indiana AGI related to intercompany interest expenses.

*Tax Amnesty:* It provides for a tax amnesty program.

The bill makes technical corrections and conforming amendments.

**Effective Date:** July 1, 2015; January 1, 2016; January 1, 2017.

**Explanation of State Expenditures:** *Department of State Revenue (DOR):* The DOR will incur additional expenses to revise tax forms, instructions, and computer programs to reflect the changes made by the bill. With the exception of the required tax amnesty program, the DOR's current level of resources should be sufficient to implement these changes.

When the DOR conducted a tax amnesty program in 2006, the total cost was about \$15.5 M. That included contracting with an outside collections agency to assist with the project because the DOR did not have the capacity or resources to contact all potential amnesty cases. It is unknown whether the DOR currently has the resources to conduct this project without outside assistance. The bill does not appropriate funds for a tax amnesty project. The additional funds and resources required could be supplied through existing staff and resources currently being used in another program or with new appropriations. Ultimately, the source of funds and resources required to satisfy the requirements of this bill will depend on legislative and administrative actions.

**Explanation of State Revenues:** The table below summarizes the estimated impact of provisions in the bill. (Provisions having no fiscal impact are excluded from the table.) Following the table are brief explanations of the provisions and potential revenue impacts. The provisions are categorized based on whether they are: (1) likely to increase state revenue, (2) likely to have no fiscal impact, or (3) likely to decrease state revenue.

Provision	Estimated Impact (\$ in millions)		
	FY 2016	FY 2017	FY 2018
Sales Tax - Double Direct Test	(\$54.0 - \$100.0)	(\$130.0 - \$240.0)	(\$130.0 - \$240.0)
Business Income	*	*	*
Intercompany Interest Expense Add Back	*	*	*
Tax Amnesty	\$0	\$109 - \$159	\$0
Income Tax - Eliminating Adjustments, Deductions, and Credits	\$0	\$8.2	\$8.0
<b>Total</b>	<b>(\$54.0 - \$100.0)</b>	<b>(\$12.8 - \$72.8)</b>	<b>(\$122.0 - \$232.0)</b>

\* Indeterminable fiscal impact.

*Likely to Decrease State Revenue -*

(Revised) *Sales Tax - Double Direct Test:* The bill broadens the sales tax exemption for production inputs and exempts sales of certain production inputs that are not currently sales tax exempt. The bill does this by eliminating the requirement for exempt inputs to be directly consumed in direct production of a good and replacing it with a requirement for exempt inputs just to be directly consumed or used in production of a

good. The bill also extends the exemption beyond the listed industries to include all businesses that produce goods.

The revenue loss will begin in FY 2016 as businesses purchase exempt items in the first half of CY 2016, but the full revenue impact will begin in FY 2017. The estimated revenue loss associated with this provision may range from \$54 M to \$100 M in FY 2016 and \$130 M to \$240 M each fiscal year thereafter. The probability of the revenue loss being smaller than projected is minimal, but the probability of the revenue loss being larger is significant. LSA bases this assessment on (1) the potential variability of factors used for the estimate, including the estimated business share of sales tax, the estimated share of taxable input purchases by producers, and the assumed shares of taxable input purchases that could be exempted from taxation under the bill; and (2) the scale of manufacturing and other production industries in Indiana and the scale of input purchases by these industries.

[Sales tax revenue is deposited in the state General Fund (98.848%), the Motor Vehicle Highway Account (1%), the Commuter Rail Service Fund (0.123%), and Industrial Rail Service Fund (0.029%).]

#### Likely to Increase State Revenue -

*Business Income Taxation:* The bill changes Indiana's definition of business income to all income that is apportionable to the state under the Constitution of the United States. This affects what income the taxpayer must apportion when computing Indiana source income. This will likely increase state revenue by an indeterminate amount particularly from gains on liquidating sales and certain unitary transactions. The revenue impact will likely begin in FY 2016 as corporations with liability periods ending in the first half of CY 2016 file their returns, but the full revenue impact will begin in FY 2017.

*Intercompany Interest Expense Add Back:* The bill clarifies the current law related to an add back of interest expense deduction taken on a corporation's federal income tax return for certain interest expenses paid, accrued, or incurred by the corporation with one or more members of the same "affiliated group" of corporations or with one or more foreign corporations. This provision could lead to an increase in compliance by taxpayers that disregard the current add back provision due to lack of clarity in the statute.

*Income Tax - Adjustments, Deductions, and Credits:* This bill eliminates 20 income tax adjustments, deductions, and credits beginning after December 31, 2015. The net impact of eliminating these provisions could increase state General Fund revenue about \$8.2 M in FY 2017 and \$8.0 M each year thereafter. [Please see the table at the end of this document for a complete list of the provisions eliminated by the bill.]

*Tax Amnesty:* Under the bill, the DOR would adopt emergency rules to establish a tax amnesty program for listed taxes due and payable for a tax period ending before January 1, 2013. The program would not last more than eight weeks, and it would end before January 1, 2017. Using the average and median collection rates of similar programs, the proposed tax amnesty program could collect about \$109 M to \$159 M.

#### Additional Information -

*Sales Tax - Double Direct Test:* In FY 2014, Indiana collected \$7,004 M in sales tax revenue. It is estimated that about \$2,330 M of the total sales tax collections was paid by businesses, with about \$1,720 M of the total attributable to purchases of goods. These estimates are based on tax collection data, published research

estimating the business share of sales tax, and industry sector input-output data from the U.S. Bureau of Economic Analysis (BEA).

This provision affects the taxability of certain goods purchased by Indiana's production industries. Any change to the taxability of the goods purchased by those sectors is likely to have a considerable effect on state revenue. The production industries of agriculture, mining, utilities, and manufacturing comprise nearly 38% of Indiana's gross state product. The production industries may account for between \$550 M to \$660 M of the total sales tax attributable to goods purchased by businesses. Those estimates include both final goods used by businesses and intermediate inputs that are used in production but fail to meet the current double direct test. The estimates are based on an analysis of the commodity use input-output tables published by the BEA. Each industry sector is analyzed to determine which commodities would be used as intermediate inputs into the production of other tangible goods or would be a final good used by the industry. The estimated revenue loss assumes that a share of each commodity identified as a production input fails the current double direct test and is taxable, but is directly used in production so it would be tax exempt under the bill. The lower bound estimate assumes this is a 5% share and the upper bound estimate assumes this is a 10% share.

*Tax Amnesty:* Under the tax amnesty program, applicable interest, penalties, collection fees, and costs would be excused on liabilities voluntarily paid or for which a payment program acceptable to DOR is established. Also, DOR would not seek civil or criminal prosecution of the taxpayer or issue an assessment, warrant, or demand notice against the taxpayer. However, if the taxpayer fails to pay the tax liability eligible for payment under the program, the liability would be subject to a doubling of penalties imposed or otherwise due. An exception to the doubling of penalties would exist for certain taxpayers who: timely file an original tax appeal in the Tax Court; have a legitimate hold on making the payment; prove to the Commissioner that notice of the outstanding tax liability was never received; or have established a payment plan with DOR. Additionally, a taxpayer would enter into an agreement that the taxpayer would not be eligible for any future amnesty program for the same listed tax. DOR would be required to enforce the agreement.

Indiana conducted an amnesty program in 2006, and it yielded \$244 M in revenue. The table below contains the source of prior amnesty collections by tax type.

<b>Tax Type</b>	<b>% of Amnesty Revenue</b>
Corporate Income and Financial Institutions Tax	46%
Sales and Use Tax	25%
Individual Income Tax	24%
All other tax types	5%

The amnesty collection estimates are based on published research, the effectiveness of similar state amnesty programs, and the results of Indiana's prior amnesty program. The actual revenue from the proposed amnesty program depends on the total qualified tax liabilities, the success of marketing the program, and the liabilities of the taxpayers who participate in the program.

*Income Tax - Adjustments, Deductions, and Credits:* The estimates are based on Indiana income tax return data, and estimates published by the Joint Committee on Taxation. Many of the adjustments are linked to

expired federal tax provisions. Consequently, repealing these provisions would not impact AGI tax revenue unless: (1) the Congress enacts legislation to extend the provisions beyond tax year 2015; and (2) the reference in Indiana statute to the IRC in effect on a particular date is updated to include such legislation. However, Indiana taxpayers were able to adjust their AGI to account for depreciation on the costs they were not allowed to expense under Indiana code because it did not conform to certain provisions of the IRC. Eliminating those adjustments removes the mechanism for taxpayers to expense for those prior year costs. This only applies to adjustments for disaster assistance property, certain refinery property, film and television production costs, and the loss of certain preferred stocks treated as ordinary income. Also, it is assumed that some taxpayers will continue to carry forward unused credits. The bill does not prevent taxpayers from carrying forward unused credits if it was authorized by the specific credit statute.

**Explanation of Local Expenditures:**

**Explanation of Local Revenues:** *Local Option Income Taxes (LOIT):* Eliminating income tax adjustments and deductions will affect Indiana taxable income, so counties imposing local option income taxes (LOIT) could potentially experience a change in revenue. The bill also repeals the county income tax credit for the elderly or permanently disabled. LOIT collections on a statewide basis could be increased by an estimated \$2.3 M annually in FY 2016 and FY 2017. The additional revenue will continue in subsequent years.

In 2012, the county income tax credit for the elderly or permanently disabled was claimed by 677 taxpayers and reduced statewide LOIT revenue by \$23,875.

*Sales Tax:* Local revenues could decrease to the extent that a local unit receives distributions from Sales Tax revenue.

*WWI Veteran Deduction:* Under current law, WWI veterans may receive an \$18,270 property tax deduction against their residence as long as the AV does not exceed \$206,500. It is believed that there are no living WWI veterans. Elimination of this deduction will have no impact.

*Enterprise Zone Investment Deduction:* The elimination of the enterprise zone investment deduction for qualified investments made after March 1, 2016, would cause the this deduction to be phased out over the next ten years.

Currently, a taxpayer may receive a property tax deduction within an enterprise zone for up to 10 years. The deduction equals the increase in AV over the base year for qualified investments in real and personal property. As the deductions for the current qualified investments phase out, there will be no new deductions to take their place. Taxes will shift back to the current qualified property, circuit breaker losses for local units will decrease, cumulative fund levies will increase, and overall TIF revenues will increase.

For taxes payable in 2014, there were 161 real property deductions totaling \$217.5 M. The tax benefit is about \$4.1 M. About \$500,000 in taxes are shifted to other taxpayers, \$600,000 is lost to circuit breaker caps, cumulative funds lose \$277,000, and TIF proceeds are reduced by \$2.7 M.

There were also 239 personal property deductions totaling \$271.7 M. The tax benefit is about \$5.0 M. About \$2.3 M in taxes are shifted to other taxpayers, \$2.5 M is lost to circuit breaker caps, cumulative funds lose \$785,000, and TIF proceeds are increased by \$600,000 M.

**State Agencies Affected:** Department of State Revenue; Indiana Economic Development Corporation; Indiana Housing and Community Development Authority; Indiana State Education Department; Indiana

Commission for Higher Education; Ports of Indiana.

**Local Agencies Affected:** County auditors; Counties that impose a local option income tax.

**Information Sources:** LSA Income Tax database; Joint Committee on Taxation; Wolters Kluwer CCH, *2015 U.S. Master Tax Guide*, November 2014. *Tax Increase Prevention Act of 2014*, H.R. 5771, P.L. 113-295, 12/19/2014. Mengle, Rocky, *State Apportionment of Business Income*, Wolters Kluwer CCH White Paper, September 2014; LSA parcel-level property tax database; Indiana Department of State Revenue, *Indiana Tax Amnesty Final Report*, July 1, 2006; Federation of Tax Administrators, *State Amnesty Programs November 22, 1982 – Present*, September 14, 2014; Resnick, Phyllis, *The Effectiveness of Tax Amnesty Programs: 1982-2002*, Center for Tax Policy, 2002; U.S. Census, *State Government Tax Collections*; Bureau of Labor Statistics, *Quarterly Census of Employment and Wages*, 2013 Fourth Quarter, Private, All Industry; Indiana Department of State Revenue, *Tax Competitiveness and Simplification Report*, September 2014; Allied-Signal, Inc. v. Director, Division of Taxation, 504 US, 768 (1992), No. 91-615. COST, *Sales Taxation of Business Inputs*, 2005. Bureau of Economic Analysis (BEA); *Indiana GDP*; BEA, *The Use of Commodities by Industry After Redefinitions*, 2012.

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<b>Impact of Income Tax Adjustments, Deductions, and Credits Eliminated By the Bill</b>		
<b>Tax Provision</b>	<b>FY 2017</b>	<b>FY 2018</b>
21st century scholars program contribution credit	\$31,000	\$34,000
Certain trade or business deductions based on employment of unauthorized alien adjustment	(\$3,000)	(\$3,000)
Discharge of debt of a principal residence adjustment	\$0	\$0
Federal economic stimulus payment of 2008 deduction	\$0	\$0
Headquarter relocation credit	\$0	\$0
Individual development account credit	\$96,000	\$98,000
Insulation deduction	\$1,064,000	\$1,024,000
Law enforcement reward deduction	\$1,000	\$1,000
Lump sum distribution from qualified plans of participants born before January 2, 1936, adjustment	(\$132,000)	(\$129,000)
Maritime opportunity district qualifying export income deduction	\$0	\$0
Neighborhood assistance program credit	\$2,158,000	\$2,150,000
Non-Indiana locality earning deduction	\$3,760,000	\$3,699,000
Partial Indiana lottery winnings deduction	\$560,000	\$530,000
Qualified disaster assistance property adjustment	\$33,000	\$31,000
Qualified film or television production adjustment	\$7,000	\$7,000
Qualified preferred stock (Fannie & Freddie losses) adjustment	(\$165,000)	(\$158,000)
Qualified refinery property adjustment	\$736,000	\$706,000
Solar roof vent fan deduction	\$7,000	\$8,000
Tax credit for computer donations to certain educational facilities	\$0	\$0
Unemployment compensation payment in 2009 adjustment	\$0	\$0
<b>Total</b>	<b>\$8,153,000</b>	<b>\$7,998,000</b>